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UNCLAS BRASILIA 002012

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STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
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E.O. 12958: N/A

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SUBJECT: BRAZIL: WORRIES THAT POLITICAL SCANDAL WILL
DERAIL ECONOMIC GAINS

REF: A) Brasilia 1968, B) Brasilia 1973

1. (SBU) While to date the Brazilian economy has largely been immune to the growing three-month old vote-buying/influence peddling scandal which is currently plaguing the Lula administration, there are growing signs that contamination could soon occur. Between July 21 and July 25, the real dropped by 5.5 percent and the Sao Paulo Stock Exchange (BOVESPA) dropped by 5.1 percent. Although both indicators appreciated in subsequent sessions, the mantra among analysts here is that foreign investors -- heretofore attracted by the country's sky high real interest rates (near 14 percent) on Brazilian bonds -- are now viewing the country with caution.

2. (U) To ward off possible contamination, on July 27 opposition party representatives floated a trial balloon to the effect that the GOB should work with its colleagues across the aisle to fashion a consensus package of basic measures to shield the economy from the scandal in the coming weeks. That same day, Jaques Wagner, the Lula administration's Secretary for Economic and Social Development/Institutional Relations responded positively to this suggestion, noting that it would benefit all concerned.

3. (SBU) Brazil's National Confederation of Industries (CNI) is already working on a plan, which would include previously-discussed items such as tax reform, political reform, changes to the rules governing infrastructure, and reductions in government expenditures. Prior to the emergence of the scandal, the GOB had great difficulty in moving these items through the legislature as each had drawn opposition from constituencies who might have been adversely affected. Now that the Lula administration is weak and Congress is paralyzed, making progress on these measures will be even more difficult.

4. (SBU) Analysts fear that efforts to concoct such a package -- while well-intentioned -- could harm markets more than they help. Specifically, various camps will likely want to put their own stamp on any package, in many cases altering it for the worse. For instance, industries adversely affected by high nominal interest rates would likely want a commitment from the GOB to lower the benchmark SELIC rate -- thereby calling into question central bank independence. As for the left-wing of the PT, it would likely want a moratorium on external debt payments and/or an end to the GOB's 4.25 primary surplus target -- thereby calling into question the GOB's economic program in general. Even if these constituencies prove unsuccessful in grafting their desired policies onto the package, the mere fact that such proposals were circulating could in and of itself unsettle the markets.

5. (SBU) Right now, the most likely outcome, in our view, is that no package will pass. Finance Minister Palocci, who after the departure of Chief of Staff Jose Dirceu ranks as Lula's most influential advisor, can be counted on to deep six any effort to dilute/weaken the GOB's orthodox economic program. In the coming days, as before, what will likely determine how far (and how fast) any scandal-related contagion spreads to the economy is: a) the degree to which the various congressional inquiries continue to uncover additional wrong-doing and, b) whether any evidence of misconduct by Lula or Palocci surfaces.

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